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Statements on Auditing Procedure

No. 17

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Committee on Auditing Procedure,
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Physical Inventories in Wartime

THE PROBLEM

AMONG the many problems arising out of the war which particularly affect accounting is the one created by the failure of a company to make a physical count of its inventory, either all at one time or on a staggered basis throughout the year. Many companies have omitted such physical inventories this year, either voluntarily or by direction of the government, in order not to interrupt necessary production of war materials.

The foregoing circumstances raise questions as to (1) what additional or alternative auditing procedures can and should be undertaken to remedy the omission and (2) the effect on the independent accountant's short form of report. If the company does not undertake to make the customary physical count of goods in the inventory, the independent accountant obviously cannot make the usual observation or physical tests thereof in accordance with generally accepted auditing procedure.¹ Under these circumstances, to what extent is he justified in relying on alternative procedures to satisfy himself as to the fairness of inventory amounts and what is the effect on the accountant's report? For example:

- (a) Is it proper for the independent public accountant to render a report or opinion, with an exception as to the amount of the inventories?
- (b) If the inventory is material, would such exception be sufficiently important to require a disclaimer as to the ability to express an opinion on the financial statements as a whole?

DISCUSSION

Since proper answers to the foregoing questions will depend upon the circumstances in each case, the committee does not here undertake to reach categorical conclusions thereon. It believes that the

¹ Statements on Auditing Procedure No. 1, p. 6.

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conclusions in a particular case should be left to the judgment of the individual accountant determined on the basis of certain general underlying considerations. However, in order to clarify the various issues, there are set forth herein suggestions as to alternative auditing procedures and assumed circumstances which will influence the decision.

Significance of Physical Inventories

The committee desires to emphasize the fundamental difference between (a) the taking of physical inventories by a client and (b) the observation of the inventory taking or the testing of the inventories by the independent public accountant. The determination of inventory quantities, either by complete periodic physical inventory or by a consistently planned and executed system of staggered physical counts and adjustment of inventories throughout the year in connection with perpetual inventory records, is an important part of the accounting function of a corporation in reporting its financial position and the results of its operations. It is an essential responsibility of the client to determine the amount of inventory to be incorporated in his financial statements. The function of the independent accountant, on the other hand, is to satisfy himself concerning the credibility of the representations made by the client; such function, however, should in no sense be regarded as a substitution for the taking of a physical inventory by the client.

Where adequate book records of inventories are not kept, the taking of a physical inventory by the client is essential to the presentation of satisfactory financial statements; otherwise, relatively unreliable and rough estimates of inventories, obtained by the gross profit method or some similar calculation, must be used. These at best are merely calculations of the amount that *should be* on hand and not a determination of what *is* on hand. Where adequate book inventory records are maintained, the periodic physical inventory sometimes reveals substantial differences from book amounts, even in normal times. In wartime, the very circumstances which are offered as reason for refraining from the usual physical inventory-taking (i.e., high production, multiple-shift operation, constant pressure, overtime work, shortage of manpower, employment of less efficient personnel, etc.) are likely to render present book records less reliable than usual. No amount of supplementary work by the independent accountant can thus completely remedy the basic weakness resulting from the client's failure to provide some form of physical inventory.

In spite of the fundamental importance of physical inventories, recognition must, nevertheless, be given to the demands of the war

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program and to the fact that many companies are in fact compelled by circumstances to omit such procedure. However, it is urged that such omission be confined to those parts of the inventory where it is unavoidable and that the company undertake a physical count (either at one time or on a staggered basis) of all other parts of the inventory. In such cases particular care should be exercised to see that purchased materials, parts, sub-assemblies, etc., included in such physical counts, are not included also in the book balances of those parts of the inventory not physically counted.

It will no doubt be found that in most cases a physical inventory can be taken of the raw materials, supplies, and finished goods without interrupting production of war goods, and that it is the physical count of the work-in-process inventory which would be most likely to hamper such production. The following discussion of auditing procedures, therefore, refers primarily to work in process, on the assumption that the company will usually be able to make a physical check, either at one time or on a staggered basis, of the other parts of the inventory.

Alternative Procedures

Where no physical inventory of work in process is taken by a company, the inventory amounts must necessarily be based on book records, and the independent accountant's alternative procedures must be based on such records. To the extent that the work-in process inventory can be broken down and a section or sections of it can be checked by the independent public accountant by physical inspection without interrupting production, consideration may well be given to whether these procedures are an acceptable alternative. Where physical inspection cannot be made by the independent public accountant, the only remaining procedures available are confined to the accounting records and statistical data. Reliance upon them would require sufficient tests of such records and supporting data, based on a careful review of the system of accounting and internal control, to satisfy the accountant, as far as is possible in such a limited examination, as to the fairness of the inventories as a whole.

Probably the most satisfactory accounting record of work in process is a perpetual inventory record which ties in directly with a general ledger control account. In many cases, however, general ledger control accounts of work in process are not supported by formal perpetual inventory records, but by some form of underlying detailed cost records. Properly maintained, such detailed cost records may in some cases be equivalent to perpetual inventory records relating to work in process, and are, therefore, sometimes susceptible of stag-

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gered physical check. This is particularly true of those industrial operations which are basically of the "job cost" type, which is characteristic of some companies engaged on war contracts where the continuance of production is vital. However, it should be pointed out that the work-in-process inventory is constantly changing in form and amount and its complicated nature requires of the independent accountant a greater degree of skill than is ordinarily required in the case of raw material or finished stock.

There will no doubt be cases where the only accounting record of work in process is a general ledger account, there being no underlying detailed cost records which would serve as a basis for validating the total amount of work in process. Under such circumstances the total dollar amount could not be checked without listing the quantities of all the stock covered by the general ledger account and extending them at cumulative unit costs; test checking of quantities, therefore, would not be feasible. The accountant could make an exhaustive test of the entries by which the book amounts had been developed, but this could not be considered as a satisfactory substitute for a listing of the stock and physical inventory by the company.

Where a company maintains a current book record of the amount of work in process, whether supported by detailed records or not, actual or estimated costs must be used as a basis for relieving the account of goods sold or transferred to finished stock. The independent accountant should undertake a careful review of such costs in order to satisfy himself as to their propriety in the light of existing conditions. Particular consideration should be given to the advisability in many cases of revising, or weighting, standard costs to conform with new conditions, such as change-over from civilian to war production, greatly increased production, higher wages and material costs, deferred repairs and maintenance, etc. Obviously, standard costs based upon normal production are not suitable without review, and probably modification, for production on a greatly increased scale.

In addition to the usual accounting records, production and engineering data will often furnish further evidence as a basis for over-all and specific tests to support, within broad limits, the reasonableness of book inventories of work in process. Such data may include production schedules, records of units in process at the balance-sheet date and completed thereafter, reports of engineers as to percentage of completion of contracts, percentage of capacity of operation, etc. Information as to units and cost of goods completed shortly after the inventory date may be especially helpful to the accountant in substantiating the work-in-process inventory.

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In the case of all companies using strategic materials subject to priority ratings, and particularly those engaged on war contracts calling for essential military equipment and supplies, there is an obligation to maintain some form of production scheduling and planning records in order to comply with W.P.B. reporting requirements and regulations.² These records governing the flow of materials can serve also as a helpful medium for corroborating the credibility of the related inventory amounts.

Experience has shown that in many cases the difficulties arising in the absence of ordinary physical inventories can be minimized by consultation between the accountant and his client in advance of the year-end. For example, arrangements can be made for partial physical inventories or for the preparation of data supporting the work in process. In some cases it may be feasible to take physical inventories on a staggered basis where it would be inexpedient to take them all at one time.

The aforementioned alternative procedures which might be undertaken by the independent accountant where a company fails to make a physical check of all or part of the inventory, are set forth on the assumption that the company has some form of book record of inventory. Otherwise, the amount of inventory would have to be determined by very rough over-all estimates which in most cases would be too unreliable to provide a basis for an informed opinion as to the financial statements as a whole.

Effect on the Independent Accountant's Report

Before reaching conclusions as to the effect of the omission of adequate physical inventory-taking on the independent accountant's short-form report, it may be desirable to review briefly certain of the previous pronouncements of this committee. Observation or tests of physical inventories by the independent accountant, where practicable and reasonable, were recognized as generally accepted auditing procedures in "Extensions of Auditing Procedure."³ Under a subsequent amendment to this bulletin,⁴ the failure to make such physical tests was held to require disclosure in the short form of report, "regardless of whether they are practicable and reasonable, and even though the independent accountant may have satisfied himself by other methods."

² Under the Controlled Materials Plan, which is to become fully operative on July 1, 1943, bills of materials and production schedules based on contracts or orders are essential to the obtaining of allotments of scarce materials.

³ Statements on Auditing Procedure No. 1.

⁴ Statements on Auditing Procedure No. 12.

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The question of omitting physical inventories was previously presented to the committee in 1941, at which time "it was mutually agreed that there could properly be no relaxation of generally accepted standards."⁵ This view was reiterated in "Auditing Under Wartime Conditions" when it was said "that during this emergency the standards of professional work should not be lowered and the auditing procedures now in force should be maintained."⁶ Hence when the failure of a client to make a physical check of its inventories (either at the year-end or on a staggered basis throughout the year) precludes observation or physical tests by the independent accountant, this represents a departure from generally accepted auditing procedures which should be disclosed in the section of the report dealing with the scope of the examination, regardless of alternative procedures undertaken and regardless of whether the accountant has otherwise satisfied himself as to the fairness of the inventory amounts.

There remains the question as to the effect of the omission of physical inventories by a client upon the opinion expressed by the independent accountant. This opinion will necessarily be affected by the extent to which the accountant has been able, as a result of the alternative or additional procedures he has adopted, to satisfy himself regarding the amount of the inventory. The extent to which this is possible may vary; for example:

- (1) If the company has adequate records and effective inventory control, it may be possible for the accountant to adopt alternative procedures which are substantially the equivalent of observation of inventory taking or a test check of quantities and which result in his being able to form an unqualified opinion regarding the amount of the inventory;
- (2) In other circumstances, even though unable to satisfy himself, except within broad limits, as to the amount of the inventory he may be able to satisfy himself, by evidence of the more general character indicated above, that any discrepancy in the amount shown could not be sufficiently large to distort seriously the position of the company or the results of its operations as reported;
- (3) The situation again may be such that there are no effective means of reaching even the conclusion indicated under (2).

In general, where the independent accountant has satisfied himself in the manner and to the extent indicated in (1) above, there would appear to be no need for him to qualify the opinion he expresses

⁵ Annual report to council, 1941 Yearbook, p. 107.

⁶ Statements on Auditing Procedure No. 10.

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regarding the financial statements. However, where the amount of inventory involved is material the committee believes it advisable that the section of the report dealing with the scope of the examination be expanded by the insertion of a paragraph setting forth the alternative procedures undertaken, on the strength of which the accountant expresses his opinion.

Where, as in (2) above, the accountant has been able to satisfy himself in the absence of a complete physical inventory that the discrepancy could not be sufficiently great to distort seriously the position of the company or the results of its operations, and particularly if a reserve has been set up to make reasonable provision for possible overstatement, the committee believes that it would be appropriate for the accountant to express an opinion upon the financial statements as a whole, but with an exception regarding the inventories. In this case, in addition to the exception in the opinion paragraph, it would probably be necessary also to insert in the report an explanatory statement dealing more fully with the situation.

In the circumstances indicated in (3) above, where the records and other supporting data are inadequate to satisfy the accountant as to the credibility of the inventory amounts, and where the amounts involved are material in relation to the financial position and results of operations, the committee believes that the accountant should disclaim sufficient basis for the expression of an informed opinion regarding the financial statements as a whole. The situation would come within the scope of the following statements contained in "Extensions of Auditing Procedure":

"The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary. In such circumstances, the independent certified public accountant should limit his report to a statement of his findings, and, if appropriate, his reasons for omitting an expression of opinion."

Position of the Securities and Exchange Commission

The Securities and Exchange Commission in its Accounting Series Release No. 30, issued in January, 1942, permits the omission of the customary taking of inventory where such taking would curtail production of war materials, "so long as all reasonable and practical alternative measures are taken by the company and its independent

¹ Statements on Auditing Procedure No. 1, p. 5.

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public accountants to assure the substantial fairness of inventory amounts stated in the financial statements and proper disclosure is made." Companies coming under this requirement should consult with the S.E.C. in advance in order to clarify any questions as to the acceptability of alternative procedures proposed.

The S.E.C. release requires, among other things, that the accountant's report shall contain statements as to the extent to which normal procedures were omitted, the reason therefor, the extent of the accounting records and controls as to inventories, an opinion as to their adequacy and a description of the supplementary procedures undertaken. The release continues: "In many cases, it is probable that by means of their alternative and extended procedures the independent public accountants will have satisfied themselves as to the substantial fairness of the amounts at which inventories are stated, and in such case a positive statement to that effect should be made. In some cases it may be that, while the scope of procedures followed will not be such as to have so satisfied the accountants, they will be able to take the position that on the basis of the work done they have no reason to believe that the inventories reflected in the statements are unfairly stated."

The release also refers to cases in which "the scope of the work done or the results obtained from the procedures followed or the data on which to base an opinion are so unsatisfactory to the accountants as to preclude any expression of opinion, or to require an adverse opinion" and states that in such cases the "situation must be disclosed not only by an exception referring to the scope of the audit, but also by means of an exception in the opinion paragraph as to the fairness of the presentation in the financial statements."

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